IN THE
SUPREME COURT OF MISSOURI

No. SC86441

SOUTHWESTERN BELL TELEPHONE COMPANY,

Respondent,

v.

DIRECTOR OF REVENUE,

Appellant.

Petition For Review
From The Administrative Hearing Commission,
The Honorable Karen A. Winn, Commissioner

APPELLANT'S BRIEF

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ATTORNEYS FOR APPELLANT DIRECTOR OF REVENUE

Table of Contents

Table of Authorities

Cases

Constitutional and Statutory Authorities

Jurisdictional Statement

This is a petition for review of a decision by the Administrative Hearing Commission, reversing the Director of Revenue's denial of a refund of use and sales tax on Southwestern Bell's purchase of various items. The petition was filed pursuant to Missouri Supreme Court Rule 100.02, and §§ 621.050 and 621.189, RSMo. 2000. This Court has exclusive jurisdiction over this matter, as it involves the construction of the revenue laws of this state. Mo. Const. Art. V, § 3.

Statement of Facts

I. Procedural history

This case – coming to this Court now for the second time, after remand to the Administrative Hearing Commission (AHC) – began with a request by Southwestern Bell for a refund of use taxes paid during the second quarter of 1992. Appendix ("App.") A1.[1] After the Director denied the request, Southwestern Bell filed a complaint with the AHC on April 10, 1997. The AHC sustained the Director's decision on July 26, 2001, holding that telephone service did not involve "manufacturing," and thus that Southwestern Bell was not entitled to a refund.

[1] The AHC decision is found in the Appendix at A1 and in the administrative record at 51. In this brief, we cite to the Appendix pages and, when referencing the AHC's findings of fact, to the pertinent numbered paragraph in the AHC decision.

As discussed further below (Section III, infra), this Court reversed the AHC, held that telephone service does involve manufacturing, and remanded the case to the AHC. *Southwestern Bell Tel. Co. v. Director of Revenue*, 78 S.W.3d 763, 768 (Mo. banc 2002) (*SW Bell I*).

On remand, the AHC convened another hearing. On October 28, 2004, the AHC held that Southwestern Bell was entitled to a refund of all the use taxes at issue – *i.e.*, that all of the purchases were of machinery and equipment that is "used directly for manufacturing" (§144.030.2(4)& (5)). App. A71.

The Director filed a timely Petition for Review in this Court.

II. The telephone system.

The underlying facts have now been set out twice by the Administrative Hearing Commission and once (in abbreviated form) by this Court. We set them out in a somewhat different fashion here, to emphasize the functional aspects of the telephone system in which the

equipment and materials whose purchase is at issue are used.

The system Southwestern Bell uses to provide telephone service is "composed of three basic building blocks: loop facilities, central switching offices, and interoffice trunking facilities." App. A2 ¶ 1. Below we will describe the telephone system in four parts, breaking the telephone sets and accompanying wiring and equipment that are owned, maintained, and operated by the customer out from the "loop facilities" "building block." Thus, we discuss below: (1) the equipment that manufactures transmittable signals and reproduces voices (telephone sets); (2) the equipment that carries those and other signals to and from customers' telephone sets (the "loop facilities" provided by the telephone company); (3) the equipment that directs signals between particular pairs of customer lines ("central switching offices"); and (4) the equipment that carries signals between central switching offices ("interoffice trunking facilities"). We then address (5) equipment used in

central switching offices and elsewhere to provide "vertical services."

A. The telephone set.

This Court's discussion of "manufacturing" in ***SW Bell I*** requires that we consider separately the part of the telephone system with which we individually interact. In ***SW Bell I***, the Court reversed the AHC finding that the telephone system did not involve "manufacturing." The Court explained why and where "manufacturing" occurs in the telephone system:

> [T]he human voice . . . cannot be heard from residence to residence, from office to office, or from town to town. The listener requires that the voice be "manufactured" into electronic impulses that can be transmitted and reproduced into an understandable replica. The end "product" is not the same human voice, but a complete reproduction of it, with new value to a listener who could not otherwise hear or understand it.

SW Bell I, 78 S.W.3d at 768. We begin, then, at that point.

The only part of the telephone system that receives the human voice is the telephone set that sits on the customer's desk or hangs from the customer's wall. There, the "sound of the customer's voice excites the carbon particles within the mouthpiece, causing them to vibrate and produce an analog reproduction of the customer's voice." App. A15 ¶ 48. It is the telephone set, then, that "takes [the] air pressure waves" of the human voice "and converts them to electrical signals" (*id.*) – or, to put it in the language of this Court, manufactures from a voice "electronic impulses that can be transmitted and reproduced into an understandable replica." *SW Bell I*, 78 S.W.3d at 768.

At the other end of the telephone call, another telephone set performs the same function in reverse, converting the "electrical signals" that comprise an "analog reproduction of the customer's voice" into sound

waves that the customer's ear can hear.[2] Again, using this Court's language, it is the telephone set that creates a "complete reproduction" of the original voice. *SW Bell I*, 78 S.W.3d at 768.

These days the telephone set is normally owned, maintained, and operated by the customer – not by the telephone company. In a video presentation (Exhibit 42), SW Bell's expert explained to Commissioner Winn that customers are responsible for everything on their side of the "network interface device," which for residential customers, as he showed, sits outside the home. *See*

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[2] Curiously, though the AHC findings address other functions at that end of the call, the AHC never made a finding as to this crucial aspect of telephony. It is evident from findings the AHC did make (¶59-60, A18) and from the transcript (*e.g.*, Apr. 27, 2000 Tr. at 537, 647, 650), however, that this is a necessary corollary of the findings as to the function of the receiving telephone set (*e.g.* App. A15 ¶ 50).

also Exhibit 43; April 25, 2000 Tr. at 334-35. That includes the telephone set. The telephone set operates with electrical current provided by the telephone company through the network interface. *See* App. A15 ¶ 49.

Of course, the telephone set does more than just create, transmit, receive, and recreate the voice. It also creates signals that convey information to the telephone company, such as that the customer is ready for service (App. A15 ¶ 49) and the number that the customer wishes to call (*id.*; App. A16 ¶ 52). And it converts electrical signals generated by the telephone company into audible dial tones (App. A16 ¶ 51), recorded announcements (App. A17-A18 ¶ 57), busy signals (App. A18 ¶ 58), and ringing tones (App. A18 ¶59). The telephone set receives those as analog electronic signals.

For a telephone company to successfully provide and market "telephone service" to customers, it may be necessary to provide those audible tone services. But Southwestern Bell did not prove, and the AHC did not

find, that they are used or necessary either to manufacture the "electronic impulses that can be transmitted and reproduced into an understandable replica" or to manufacture that replica. Indeed, if a customer provided its own source of electricity, there would be no bar to the customer performing such "manufacturing" entirely on its own equipment, within its own independent telephone network. And many homes and businesses do exactly that in the form of "intercom" systems, the equivalent of having an independent, internal telephone system. Those systems "manufacture" in precisely the same way the Court said in *SW Bell I* the telephone system does. But there is neither a finding nor a basis in the record for a finding that Southwestern Bell is a player in such "manufacturing."[3]

[3] Sometimes the telephone company provides similar services. Missouri statutes thus speak of "dedicated, nonswitched, private line and special access services and for central office-based switching systems which

substitute for customer premise, private branch exchange (PBX) services." § 392.200.8.

Pay telephones may be the exception. The AHC made no findings regarding pay telephones themselves – not regarding ownership, operation, or maintenance. But from the AHC holdings, it appears that Southwestern Bell does own and operate some pay telephone sets. *See* App. A69. The Director does not dispute that pay telephones, like other telephone sets, manufacture both the transmittable electronic signals and audible reproductions of voices and other information carried via electronic signals.

B. "Loop facilities."

Most of us have not connected our telephone sets to our own power sources. Though the multiple telephones in a home are connected, those connections occur at the "network interface device" that hangs outside. *See* Exhibit 42 and 43. We can talk with those on other telephone sets within our own home, but we must do so over the sound of the dial tone supplied, along with electric current, by the telephone company.

We accept that situation because we do not acquire and install telephone sets for the purpose of intra-home communication. If we want to speak with someone in our home, we have simple alternatives – moving where they are, or shouting. We acquire and install telephone sets to enable us to communication with other homes and businesses. That service – the service that admittedly gives value to the "manufacturing" done by the telephone sets that we own and operate – is provided by Southwestern Bell and other telephone companies.

Southwestern Bell connects its system with those of its customers at "network interface devices"; the portions of the Southwestern Bell system that connect to our own wiring at that point are what the AHC called "loop facilities." App. A2 ¶ 1. *See* also Exhibit 43 (videotape showing interface devices). The immediate connection among telephones (or, more accurately, among "network interface devices") is the "loop." At the "network interface device," the "loop" accepts the analog signals that are produced by telephone sets and

transmits them to a central office "switch." *See* Exhibit 43. At another "network interface device" at the other end of the call, another "loop" delivers the analog signal that the receiving telephone set requires to create an audible reproduction of the original voice. *Id.*

The AHC appropriately divides "loop facilities" into two parts: "feeder" and "distribution" facilities. *See* App. at A11 ¶ 33. "Distribution" facilities actually carry signals to and from individual "network interface devices." "Feeder facilities start at the central office location and proceed toward large concentrations of customers." *Id*. They most commonly meet at "a feeder/distribution interface ('FDI') – or cross-connect box." App. A13 ¶ 40.

Copper cable "is still usually the most economical choice" for feeder lines "for locations very close to the central office." App. A11 ¶ 34. Sometimes the load on the cable is so large as to make it economical to use "pair gain" devices to increase the capacity of the

copper cable. App. A12 ¶ 35-37. "Pair gain" devices expand the number of customers who can be served with a single feeder cable. App. A12 ¶37. They "convert the analog signal" produced by each telephone set "and put it on a carrier frequency" (*id*.), which the AHC describes "as a modulation of the voice frequency" (App. A3 ¶ 4).

In some instances, Southwestern Bell chooses to replace the wiring in a "feeder" system with fiberoptic cable, which can carry far more information than copper cable – far more even than cable used with a "pair gain" device. App. A13-A14 ¶¶ 41-42. To use fiberoptic cable, the telephone company must add equipment that converts the analog signal manufactured by the telephone set into a digital signal that can be carried by fiberoptic cable. *See* App. A13-A14 ¶ 41. The AHC explained that "[d]igital technology converts the information to be transmitted," the analog signal, "into a series of zeroes and ones, or 'off' and 'on' signals." App. A3 ¶ 3.

In some instances, there is a digital loop on the distribution side of the feeder/distribution interface.

See App. A14-15 ¶¶ 44-45. Those, too, require equipment to transform the analog signal manufactured by the telephone set into a digital signal and digital signals back into the analog ones that the customer requires to operate a telephone set. *Id*.

The AHC did not find, and Southwestern Bell did not show, that distribution and feeder systems are necessary to the "manufacture" of reproducible voice signals (except insofar as they are a source – though not the only practical source – of electricity for telephone sets). Distribution and feeder systems simply function to carry such signals and other information to and from central office switches, discussed below.

C. "Central switching offices."

The next "building block" is the "central switching office." App. 2 ¶ 1. It is the key element in providing telephone "service" – but not in creating from voice a transmittable signal, nor in creating an audible reproduction of the original voice. At the "central switching office," electronic signals produced by one

telephone set are directed to another, specified telephone set, and returning signals are directed to the originating set. *See* Exhibit 43. That is what differentiates "telephone service" from "intercoms."

The AHC explains the switching function in some detail. To summarize, the switch takes the information sent over the "loop" by the customer – the phone number dialed – and attempts to open a link to the "network interface device" assigned to that number. Depending on what information is relayed back from a telephone set connected to the interface, the switch then either establishes a connection over which the two telephone sets can exchange signals, or sends a message back to the dialer indicating that the dialed number is unanswered or unavailable. *See* App. A4-A9 ¶¶ 10-24.

Some "switching" takes place at locations other than a "central switching office." "Remote switching systems" "share the capabilities of the host switch" at the central office." App. A8-9 ¶ 23. They are located "in small, densely populated areas within a large exchange

or to serve a smaller exchange that is close to a larger office." *Id*.

But whether "remote" or "central," the "switches" are complex machines that perform functions other than just making connections over which manufactured signals travel. They produce dial tones, ring tones, and busy signals, and other signals that convey information to the originating telephone set. And, as discussed in part 5 below, they are involved in the manufacture of some "vertical services."

D. "Interoffice trunking facilities."

The last "building block" of the telephone system consists of "the communications paths between the switching machines" – what the AHC called "interoffice trunking facilities." App. A2 ¶ 1; App. A9 ¶ 25.

These may take various forms. "The simplest form of interoffice trunking facility is a pair of copper wires" (App. A9 ¶ 26) – the same kind of wires used in basic distribution loops. "Trunks of this type can carry analog or digital signals . . . ." *Id*. More "modern" are "lightwave guide systems, or fiber-optic systems." App. A10 ¶ 29.

Whether the lines carry analog or digital signals, from time-to-time the signals must be strengthened. "Analog signals deteriorate as they travel through various parts of the network," and "must be amplified at relatively short distances." App. A2-3 ¶ 2. "Digital signals do not deteriorate as rapidly as analog signals and therefore can travel longer distances without amplification." *Id*. "However, even a digital signal

deteriorates, so it must be regenerated by a repeater approximately every 6,000 feet, which reformats the signal." App. A10 ¶ 27. "The fibers being used today can transmit a light signal 30 miles without the need for repeaters or regenerators." App. A10 ¶ 29.

Of course, nothing in the "trunking facilities" manufactures an electronic signal – digital or analog – from a voice. Nor does anything in those facilities manufacture an audible signal from an electronic one. The trunking facilities merely carry signals from one place to another. To the extent they convert analog signals to digital ones, or recreate and retransmit digital signals, that is only necessary as part of the transmission process. *See* A3, A9-A11, A21-A22.

E. "Vertical services."

The AHC addressed a list of "vertical services" – *i.e.*, services that Southwestern Bell offers to the customer in addition to the transmission of electronic signals necessary for voice communication: "customer billing report, detailed billing of local measured

service, autoredial, call blocker, call forwarding, selective call forwarding, call return, call trace, call waiting, priority call, and three-way calling." App. A23 ¶ 80.[4]

[4] The AHC also mentioned four other "vertical services" that Southwestern Bell offered later, and are at issue in refund claims for later quarters: "CABS bills on floppy disk, caller ID, anonymous call rejection, and remote access call forwarding." App. A23 ¶ 80. The AHC also mentioned "Bill Plus," which was apparently in the trial stages during the quarter at issue. *Id*.

These services are made possible, in part, by the use of "signaling, . . . the generation, transmission, reception, and application of conditions that are needed to direct and control the setup" or the telecommunications network. App. A22 ¶ 76. "Signaling" is made possible by the use of the "SS7 network," which "allows the switching machines to communicate with each other on a path different from that used by the voice communication that is being made." App. A23 ¶ 77. The SS7 network "transmits between switches," but "does not carry the voice trunking between offices. App. A23 ¶ 77. The SS7 is used – but not required – in providing basic telephone service. App. A24 ¶ 82.

Many of the "vertical services" involve the creation of signals that are transmitted to the customer and converted into usable (*i.e.*, audible or visual) information by the customer's own telephone set. For example, call waiting creates a tone signaling a second incoming call. *See* Exhibit 43.

Some of the "vertical services" are "produced from the originating switch and do not require an SS7" network, *e.g.*, call forwarding, call waiting, speed calling, and three-way calling. App. A24 ¶ 83.

Other "vertical services" are related purely to billing – *i.e.*, they simply allow the telephone company to bill the customer for different services. *See* App. A24 ¶ 85. The AHC did not find, nor did the evidence presented by Southwestern Bell show, that billing services involve the creation of any signal that is sent through the telecommunications system to the customer's telephone set.

Points Relied On

A. The AHC erred in finding that equipment used by Southwestern Bell in providing telephone service is exempt from sales and use tax because that equipment is not used directly in manufacturing in that the manufacturing itself – the creation of a transmittable signal from a voice and the transformation of such a signal into a reproduction of a voice – takes place on equipment that is owned, maintained, and operated at a different location by a different person.

Southwestern Bell Tel. Co. v. Director of Revenue, 78 S.W.3d 763 (Mo. banc 2002)

West Lake Quarry & Material Co. v. Schaffner, 451 S.W.2d 140 (Mo. 1970)

Utilicorp United, Inc. v. Director of Revenue, 75 S.W.3d 725 (Mo. banc 2001)

Branson Properties USA, L.P. v. Director of Revenue , 110 S.W.3d 824 (Mo. banc

2003)

§ 140.030.2(4) & (5), RSMo. 2000

B. The AHC erred in finding that purchases of machinery and equipment are entitled to the "manufacturing" exemption merely because they "operate harmoniously" with manufacturing equipment because that is not the test under the statute, even applying the "integrated plant doctrine," in that the statute requires actual use "in" manufacturing, not merely in connection with or alongside manufacturing.

Floyd Charcoal Co., Inc. v. Director of Revenue, 599 S.W.2d 173 (Mo. 1980)

Niagara Mohawk Power Co. v. Wanamaker, 144 N.Y.S.2d 458 (App. Div. 1955)

§ 140.030.2(4) & (5), RSMo. 2000

C. The AHC erred in finding that equipment used to provide some "vertical services" is exempt from sales and use tax because that equipment is not used directly in manufacturing a product in that it is used merely to bill customers for a product manufactured by other equipment.

Southwestern Bell Tel. Co. v. Director of Revenue, 78 S.W.3d 763 (Mo. banc 2002)

§ 140.030.2(4) & (5), RSMo. 2000

D. The AHC erred in finding that the purchase of equipment used in "interoffice trunking facilities" is exempt from sales and use tax because that equipment is not used directly in manufacturing a product in that such equipment is merely used to provide a service, *i.e.*, transmission.

West Lake Quarry & Material Co. v. Schaffner, 451 S.W.2d 140 (Mo. 1970)

Utilicorp United, Inc. v. Director of Revenue, 75 S.W.3d 725 (Mo. banc 2001)

Floyd Charcoal Co., Inc. v. Director of Revenue, 599 S.W.2d 173 (Mo. 1980)

Niagara Mohawk Power Co. v. Wanamaker, 144 N.Y.S.2d 458 (App. Div. 1955)

§ 140.030.2(4) & (5), RSMo. 2000

Argument

I. Principles of appellate law.

A. Standard of review.

The key questions raised here deal with the meaning of § 144.030.2(4), a revenue law. "'Interpretations of the state's revenue laws by the [Administrative Hearing Commission ("AHC")] are reviewed de novo . . . .'" *Holm v. Director of Revenue*, 148 S.W.3d 313, 314 (Mo. banc 2004), quoting *Sprint Communications Co., L.P. v. Director of Revenue*, 64 S.W.3d 832, 834 (Mo. banc 2002) (overruled on other grounds in *Hampton v. Big Boy Steel Erection,* 121 S.W.3d 220, 223 (Mo. banc 2003)). See also §§ 621.193, 621.189, 621.050, RSMo. 2000.

The appeal also raises some questions concerning the application of the law to the facts. AHC decisions regarding such questions "are upheld when authorized by law and supported by competent and substantial evidence upon the record as a whole unless clearly contrary to the reasonable expectations of the General Assembly." *Holm v. Director of Revenue*, 148 S.W.3d at 314.

"Substantial evidence," in turn, "is evidence, which if true, has probative force; it is evidence from which the trier of fact reasonably could find the issues in harmony therewith." *Id*.

B. Canons of statutory construction.

The particular law at issue is one creating an exemption from sales and use taxes that would otherwise apply to the property and purchases involved in this case. "Tax exemptions are strictly construed against the taxpayer." *Branson Properties USA, L.P. v. Director of Revenue*, 110 S.W.3d 824, 825 (Mo. banc 2003), citing *Director of Revenue v. Armco*, 787 S.W.2d 722, 724 (Mo. banc 1990).

Consistent with that rule, the taxpayer, Southwestern Bell, "has the burden to show it qualifies for an exemption." *Branson Properties*, 110 S.W.3d at 825, citing *Utilicorp United, Inc. v. Director of Revenue*, 75 S.W.3d 725, 727 (Mo. banc 2001). "An exemption is allowed only upon clear and unequivocal proof, and doubts are resolved against the party claiming it." *Branson Properties*, 110 S.W.3d at 825, citing *House of Lloyd v. Director of Revenue*, 824 S.W.2d 914, 918 (Mo. banc 1992), overruled on other grounds by *Sipco, Inc. v. Director of Revenue*, 875 S.W.2d 539,

541-42 (Mo. banc 1994). "Exemptions are interpreted to give effect to the General Assembly's intent, using the plain and ordinary meaning of the words." *Branson Properties*, 110 S.W.3d at 825-26, citing *Rotary Drilling Supply, Inc. v. Director of Revenue,* 662 S.W.2d 496, 499 (Mo. banc 1983).

C. Law of the case doctrine.

This is, of course, the second time this matter has been brought to this court. Thus its consideration implicates the doctrine of "the law of the case," which "governs successive appeals involving substantially the same issues and facts." *State v. Phillips*, 324 S.W.2d 693, 694 (Mo. 1959), quoted with approval in *Williams v. Kimes*, 25 S.W.3d 150, 153 (Mo. banc 2000). Under that doctrine, the Court's "previous holding is the law of the case, precluding re-litigation of issues on remand and subsequent appeal." *State v. Graham*, 13 S.W.3d 290, 293 (Mo. banc 2000), quoted with approval in *Kimes*, 25 S.W.3d at 153-54. But this Court retains "discretion to consider an issue where there is a mistake, a manifest

injustice, or an intervening change of law." *State v. Johnson*, 22 S.W.3d 183, 189 (Mo. banc 2000), quoted with approval in *Kimes*, 25 S.W.3d at 154.

II. Principles and history of interpretation and application of the revenue laws: The "manufacturing" exemption and the "integrated plant" doctrine.

This appeal involves an exemption to the Missouri sales and use taxes. Those taxes are applicable to all purchases (§ 144.020.1(1)) except those that fall into a long list of exceptions, found in § 144.030. At issue here are two largely parallel exemptions for items used to manufacture other, taxable, items:

> 2. There are also specifically exempted from the provisions of the local sales tax law . . .:
>
> (4) Replacement machinery, equipment, and parts and the materials and supplies solely required for the installation or construction of such replacement machinery, equipment, and parts, *used directly in*

manufacturing, mining, fabricating or producing a product which is intended to be sold ultimately for final use or consumption . . . .

(5) Machinery and equipment, and parts and the materials and supplies solely required for the installation or construction of such machinery and equipment, purchased and used to establish new or to expand existing manufacturing, mining or fabricating plants in the state if such machinery and equipment *is used directly in manufacturing, mining or fabricating a product which is intended to be sold ultimately for final use or consumption*; . . .

§ 144.030.2 (emphasis added). These exemptions date back to 1961. A.L. 1961 p. 623, S.C.S.S.B. 360, enacted June 7, 1961. *See* § 144.030.3(3) & (4), RSMo. 1969. The provisions were moved when the section was restructured in 1979. A.L. 1979 H.B. 726 p. 257, 259-60. *See* § 144.030.2(4) & (5), RSMo. 1986. Though the current versions are longer, the language pertinent here is now nearly 44 years old.

Appeals addressing the exemptions have created three lines of precedents in this Court. The first appeal in this case raised an issue that fits within the first line of cases; the questions presented require further explanation as to the first and second line of cases, but fall most directly within the third.

A. "Manufacturing." To merit a sales and use tax exemption under § 144.030.2(4) & (5), a product must be manufactured. Thus the first line of cases addresses what constitutes manufacturing.

This Court first considered that question in *West Lake Quarry & Material Co. v. Schaffner*, 451 S.W.2d 140 (Mo. 1970). There, the Court held that taking natural stone and changing it to new and commonly usable broken and crushed rock and agricultural lime constituted "manufacturing."

The Court returned to the question two years later in *Heidelberg Central, Inc. v. Director of Dept. of Revenue*, 476 S.W.2d 502 (Mo. 1972). There the Court addressed a claim for the exemption for printing

equipment. The Court pointed out that "definitions of 'manufacturing' are somewhat helpful, but very broad." 476 S.W.2d at 504. The Court "concluded that the business of the purchasers of the printing presses involved . . . was 'manufacturing'" within the meaning of the exemption. *Id*. at 505. "The printers . . . produce[d] new and different articles from raw materials by the use of machinery, labor and skill, and they produced products for sale which had an intrinsic and merchantable value, and were in forms suitable for new uses." *Id*.

In *State ex rel. AMF, Inc. v. Spradling*, 518 S.W.2d 58 (Mo. 1974), the Court considered whether retreading tires was "manufacturing." The Court held that it was not – that "retread processes take worn tire carcasses and make them usable as opposed to the manufacture or production of a new and different tire." *Id*. at 61. In essence, retreading constitutes "repair," not "manufacturing."

The Court held the conversion of live hogs into marketable products to be "manufacturing" in *Wilson & Co. v. Department of Revenue*, 531 S.W.2d 751 (Mo. 1976).

In *Jackson Excavating Co. v. Administrative Hearing Commission*, 646 S.W.2d 48 (Mo. 1983), the Court held that transforming nonpotable to potable water is manufacturing. It "makes more than a superficial change in the original substance; it causes a substantial transformation in quality and adaptability and creates an end product quite different from the original. It creates water fit for human consumption." *Id*. at 51. The equipment at issue was at the core of the purification process. *See Jackson Excavating Co. v. Director of Revenue*, 1981 WL 11937 (Mo. Admin. Hrg. Comm'n. 1981) at *2.

In *GTE Automatic Electric v. Director of Revenue*, 780 S.W.2d 49 (Mo. 1989), the Court addressed for the first time the question of "manufacturing" in the telecommunications context. There the Court only "touched on the issue of whether telecommunications

constitutes 'manufacturing.' Primarily the Court determined that because telephone service was not a product" (the second of the three questions discussed here, Section II. B., *infra*), "it could not be manufactured." *SW Bell I*, 78 S.W.3d at 767.

Unitog Rental Services, Inc. v. Director of Revenue, 779 S.W.2d 568 (Mo. 1989), involved machinery used to clean uniforms. The Court held that such cleaning was not "manufacturing." *Id.* at 571.

In *Bridge Data Co. v. Director of Revenue*, 794 S.W.2d 204, 206 (Mo. banc 1990), the Court applied the manufacturing exemption to "collecting financial data and transmitting data," where "what comes out of the system is clearly different from what went into it."

That same year, the Court held in *L&R Egg Co., Inc. v. Director of Revenue*, 796 S.W.2d 624, 626 (Mo. 1990), that processing eggs – including cleaning, culling, weighing, and packaging – was not "manufacturing."

The taxpayer in *House of Lloyd, Inc. v. Director of Revenue*, 824 S.W.2d 914 (Mo. banc 1992), sought the

exemption for presentation kits provided to its sales force. House of Lloyd conceded that the kits were not "manufactured," but argued that they were still "fabricated." The Court held otherwise. *Id*. at 920. The Court similarly rejected the claim that "machinery and equipment used in baling scrap cardboard which is eventually sold" is exempt; again, baling is not "fabricating." *Id*. at 921.

In *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186, 191 (Mo. banc 1996), the Court affirmed that "organizing data through computer technology is 'manufacturing,'" citing *Bridge Data*. That includes the gathering of information for a newspaper – not just "the process of putting ink on paper." 916 S.W.2d at 191.

On the same day, in *Galamet, Inc. v. Director of Revenue*, 915 S.W.2d 331, 334-35 (Mo. banc 1996), the Court agreed that the production of shredded steel from scrap metal – including "automobile bodies, old pipes,

'white goods' . . . and other materials" – constitutes "manufacturing."

In *International Business Machines Corp. v. Director of Revenue*, 958 S.W.2d 554, 557 (Mo. banc 1997), the Court again confirmed that "organizing information through computer technology is 'manufacturing.'"

And in *Ovid Bell Press, Inc. v. Director of Revenue*, 45 S.W.3d 880 (Mo. banc 2001), the Court again confirmed that printing is "manufacturing."

The next decision regarding "manufacturing" was this Court's previous decision in this case, *Southwestern Bell Telephone Co. v. Director of Revenue*, 78 S.W.3d 763 (Mo. banc 2002) (*SW Bell I*). We discuss that decision further in Section III*, infra*.

The Court addressed the question of "manufacturing" most recently in *Branson Properties USA, L.P. v. Director of Revenue*, 110 S.W.3d 824 (Mo. banc 2003). There the Court summarized its prior precedents and held that although they provide a service, amusement park rides do not "manufacture" a "product." *Id.* at 827. The

Court distinguished the facts from *SW Bell I*, noting that even when the product is intangible, "there still must be a clear and identifiable transformation of an input into an output with a separate and distinct use, identity or value." *Id*.

B. "Product." The sales and use tax exemptions found in §§ 144.030.2(4) & (5) apply only to the manufacturing of "products." Thus the process being performed must not only be "manufacturing," it must produce a product.

This Court addressed the question of "product" in the telecommunications context in *GTE Automatic Elec. v. Director of Revenue*, 780 S.W.2d 49 (Mo. banc 1989). There, the court narrowly held "that voice transmission was a 'service,' not a 'product,' and that section 144.030.2 limited the exemption to products." *SW Bell I*, 78 S.W.3d at 766.

That holding almost immediately began to dissipate. "The very next year, [the holding in] *Bridge Data* substantially undercut the 'product' centered rationale

of *GTE* . . . ." *SW Bell I*, 78 S.W.3d at 766. In *Bridge Data*, the Court held that a "product" need not be "'tangible' in order for the manufacturing exemption to apply." 794 S.W.2d at 206. A few years later, in *Concord Publishing House, Inc. v. Director of Revenue*, 916 S.W.2d 186 (Mo. banc 1996), the Court reaffirmed that information that had been organized "through computer technology" could be a manufactured "product." 916 S.W.2d at 191.

The death of the *GTE* rule was formally announced in *SW Bell I*:

> Finally, the 'product' holding of *GTE* was expressly overruled in *International Business Machines Corp. v. Director of Revenue*, 958 S.W.2d 554, 557 (Mo. banc 1997). *IBM* allowed an exemption for equipment used to analyze financial data and to transmit this data to customers, either in hard copy or electronic form. *IBM* specifically stated: "Because a product is an output with a market value, it can be either tangible personal property or a

> service. To the extent inconsistent with this opinion and the recent cases, GTE's discussion of the term 'product' should no longer be followed. 780 S.W.2d at 50-52." 958 S.W.2d at 557.

SW Bell I, 78 S.W.3d at 767. Thus the Court reiterated that "a product," for purposes of the "manufacturing" exemptions, "is an output with a market value." Since *SW Bell I*, the Court has held that a manufactured product is "an output with a separate and distinct use, identity or value." *Branson Properties*, 110 S.W.3d at 827. Simply providing a service is not enough.

C. "Used directly in." That a "product" is being "manufactured" does not end the inquiry. The purchase of particular machinery or equipment falls within the exemption only if that equipment or machinery is "used directly in mining, fabricating or producing" the product. §144.030.2(4) & (5). The third line of cases are those addressing the "used directly in" requirement.

This Court first considered the question in *West Lake Quarry*. 451 S.W.2d 140 (Mo. 1970). There, the

Court addressed the distinction between equipment used to create a product and equipment used at the manufacturing site to transfer the finished product to a customer. The Court drew a line between machinery used in "processing and grinding the rock in various sizes for many different uses," which was exempt from sales and use tax, and machinery used to load customer's trucks with the finished product, which was not. *Id.* at 143. The Court thus construed the "used directly" limitation to exclude machinery used to enable a customer to pick up and carry off a finished product, even though that equipment was used at the same location as and in conjunction with the exempt equipment.

The Court returned to the subject a decade later in a pair of cases decided by different divisions of the Court on the same day: *Floyd Charcoal Co., Inc. v. Director of Revenue*, 599 S.W.2d 173 (Mo. 1980), and *Noranda Aluminum, Inc. v. Missouri Department of Revenue*, 599 S.W.2d 1 (Mo. 1980).

In *Floyd Charcoal*, the Court considered the application of the "manufacturing" exemption to various pieces of equipment, including: the "Sackamatic System and Filter," "used to sack the finished charcoal product"; the "Sewing Heads," "used to sew the sack closed at the top after briquettes have been put into the sack"; the "check weight and panel," "used to weigh the sack after the charcoal has been put into it"; and the "film bags," used "to enclose the original paper sacks which contain the charcoal . . . to protect the charcoal from moisture during transportation." *Id*. at 175.[5] To deal with such equipment and materials, the

[5] Curiously, in *Floyd Charcoal* the Court said it was addressing the "used directly" question "for the first time" (599 S.W.2d at 176), and it ignored the *West Lake Quarry* holding that machinery located at the processing site but used to place the finished product in customer's trucks was not "used directly" in manufacturing. *See* p.38-39, *supra*.

Court announced and applied the “integrated plant”doctrine.

The Court found that doctrine in decisions in the New York decision in *Niagara Mohawk Power Co. v. Wanamaker*, 144 N.Y.S.2d 458 (App. Div. 1955). The New York court decried as “not practical” the approach of dividing a single “generating plant” (there, an electrical generating plant) “into ‘distinct’ stages.” 144 N.Y.S.2d at 461-62, quoted in *Floyd Charcoal* at 599 S.W.2d at 177. Neither the New York court nor this Court gave the “integrated plant” precise boundaries. Instead, this Court eschewed the use of any “simple test” and endorsed use of the three questions posed in the New York decision: “(1) Is the disputed item necessary to production? (2) How close, physically and causally, is the disputed item to the finished product? (3) Does the disputed item operate harmoniously with the admittedly exempt machinery to make an integrated and synchronized system?” 144 N.Y.S.2d at 461, quoted in *Floyd Charcoal* at 599 S.W.2d at 177. This Court rejected the

alternative Ohio rule, under which the exemption applied only "to machinery and equipment which perform a function involving a change of the raw material involved into the finished product and excludes machinery used in preparation for manufacturing or after completion of the manufacturing process." *Id.*

The Court's first actual application of the "integrated plant" doctrine was unfortunately conclusory. Noting that Floyd Charcoal "produces charcoal briquettes . . . for distribution and sale only in packages which must be accurately weighed and closed," the Court held, without further explanation, that "the equipment involved in weighing and sacking" was an "integral part of the . . . manufacturing process." *Id*. at 178. But the Court summarily rejected the claim that the "film bags" were exempt, because nothing in the record showed that these items were used in manufacturing. *Id*. at 179.

In *Noranda Aluminum*,[6] the Court addressed eight

categories of items – none of which involved the handling or transportation of the finished product. *See* 599 S.W.2d at 3. The court spent the most time addressing "laboratory equipment designed for chemical and physical analysis of aluminum metal and to monitor the efficiency of the reduction process." *Id*. The Court found that the laboratory work was "essential to and a part of the manufacturing process" because the results of laboratory testing were necessary to "determine if there are impurities getting into the aluminum" and were "used to direct the molten aluminum into further fabricating." *Id*. at 4.

The next case in this line may be *Daily Record Co. v. James*, 629 S.W.2d 348 (Mo. banc 1982). In *Concord Publishing*, the Court cited *Daily Record* following the statement, "We have also recognized that portions of a newspaper may be produced in separate locations and by separate corporations, but still be considered part of one publication." 916 S.W.2d at 192, *citing* 629 S.W.2d at 351. But nowhere in *Daily Record* did the Court say

that there were two separate locations. And the AHC's findings identified only a "single corporation" with a "place of business at 4356 Duncan Avenue, St. Louis." *Daily Record Co. v. Director of Revenue*, 1981 WL 11940 (Mo. Admin. Hrg. Comm'n. 1981) at *1.

The Court approached the question in *Wetterau, Inc. v. Director of Revenue*, 843 S.W.2d 365 (Mo. banc 1992). There the Court addressed the meaning of §144.030.2(12), which moves beyond "mining, fabricating or producing" to include "processing." Weterrau sought an exemption for electricity used to keep frozen meat that had been processed. The Court refused to include the storage of the meat, pending customer delivery, within the scope of "processing." 843 S.W.2d at 368.

The Court reached the "used directly" question in *Concord Publishing*. There, the Court reaffirmed use of the "'integrated plant doctrine', viewing manufacturing operations as 'continuous and indivisible.'" 916 S.W.2d at 191, quoting *Floyd Charcoal*, 599 S.W.2d at 178. The Court held that a single "integrated plant could include

operations of two corporations under common ownership" (*see* 916 S.W.2d at 188), "as long as both businesses work together to manufacture a single product." *Id*. at 192. And citing *Noranda* and *Daily Record*, the Court held that a single "plant" can have diverse locations – *i.e.*, that "physical distance alone is not determinative," so long as there is a "direct tie" between the two manufacturing functions. *Id*. at 192-93. Apparently the Court was not asked, and did not address, whether that "direct tie" was itself within the "integrated plant." But the "tie" was likely a telecommunications line operated by someone else – perhaps even Southwestern Bell.

In *DST Systems, Inc. v. Director of Revenue*, 43 S.W.3d 799 (Mo. banc 2001), the Court applied the "integrated plant doctrine" to related companies producing compilations of information using computer equipment at various locations. The computers at the location in dispute "gather, store and organize all the information" that is printed and distributed. *Id*. at 803. In other words, the "mainframe computers" at one

location "run the software applications that enable the printing of products" at the other location. *Id*. The Court reiterated that the "integrated plant" can include "two corporate entities under common ownership" operating at different locations – so long as "the equipment and machinery of the two entities are 'integrated and synchronized' for the purpose of manufacturing a product intended to be sold ultimately for final use or consumption." *Id*., quoting *Concord Publishing*, 916 S.W.2d at 192. As in *Concord Publishing*, the Court did not address the equipment that connected the two locations.

This Court most recently returned to the "used directly" question in *Utilicorp United, Inc. v. Director of Revenue*, 75 S.W.3d 725 (Mo. banc 2001). There, the Court confirmed what was originally apparent in *West Lake Quarry* – but perhaps inconsistent with *Floyd Charcoal*: that equipment necessary to move a product to the customer is not "used directly in manufacturing." That is true even though the transmission of electricity

for delivery in a form usable by customers requires changes in amperage and voltage. *Id*. at 729-30.

III. *SW Bell I*

In its first decision in this case, the Court addressed the first question – the "product" – and the second – whether it is "manufactured." *See SW Bell I*, 78 S.W.3d at 767-68. The Court held that telephone service involves the "manufacturing" of a "product" – a replica or precise reproduction of a human voice:

> [T]he human voice . . . cannot be heard from residence to residence, from office to office, or from town to town. The listener requires that the voice be "manufactured" into electronic impulses that can be transmitted and reproduced into an understandable replica. The end "product" is not the same human voice, but a complete reproduction of it, with new value to a listener who could not otherwise hear or understand it.

78 S.W.3d at 768. The Court went on to observe that because a "complete reproduction" of a human voice is a

"product," "[b]asic telephone service and the various vertical services involved herein are intangible products that are manufactured." *Id*. The Court then reversed the Administrative Hearing Commission's decision, held that "[b]asic telephone service and the various vertical services involved herein are products that are manufactured," and confirmed that *GTE* had been overruled. *SW Bell I*, 78 S.W.3d at 768.[7]

But the full meaning of that holding remains unclear. The ambiguity is significant here because we cannot be certain what this Court held to be "manufacturing." In setting out its rationale, the Court had referred to one aspect of voice telecommunications – the conversion of a voice into "electronic impulses that can be transmitted and reproduced into an understandable replica" – as "manufacturing." Presumably the same is true of the corollary, *i.e.*, that reproducing an understandable replica of a voice from electronic impulses that have been transmitted is "manufacturing." If the Court had stopped there, it would seem apparent

that for Southwestern Bell to obtain the benefits of the "manufacturing" exemption for machinery and equipment that it purchases, those items would have to be used in the actual process of creating the analog signal or producing the audible reproduction. That is but a small fraction of the equipment and materials for which the AHC awarded Southwestern Bell the "manufacturing" exemption.

But the Court did not stop there. Again, it followed its specific rationale with the broad statement that "[b]asic telephone service" is a manufactured product. 78 S.W.3d at 768. But the Court did not define "basic telephone service." And there are at least three possible definitions.

Reading the term in light of the Court's preceding discussion leads to a narrow definition: that "basic telephone service" is the conversion of voice into electronic impulses, and the corresponding conversion of electronic impulses into a reproduction of voice.

Incorporating the AHC decision then on appeal in ***SW Bell I*** into the Court's decision suggests a broader definition. Though the AHC never defined "basic telephone service," it did use it as a section heading in its decision. ***See Southwestern Bell Tel. Co. v. Director of Revenue,*** 2001 WL 34064255 (Mo. Admin. Hrg. Comm'n. 2001), at *8.[8] That section contained few references to the single process that this Court later described as "manufacturing." ***See*** A.R. 22, 24, ¶¶ 47, 54, 55. Most of the section related to the transmission of electrical impulses and the operation of switches. But it did discuss the creation of electronic impulses by things other than voice, ***i.e.***, the creation of pulses or tones to provide numeric phone number information to switches (A.R. 21, ¶ 44) and the creation of what we recognize as "busy signals" (A.R. 21, ¶ 45) and "audible ringing signals" (A.R. 21-22, ¶ 46). It is possible, then, to conclude that the AHC implicitly defined "basic telephone service" as that portion of the telecommunications system that receives information from

the customers' telephone sets and responds with busy signals, ringing tones, or by connecting customers. That would be consistent with the AHC's use of the term elsewhere in its 2001 decision. *E.g.*, A.R. 14, ¶ 19 (electronic switching systems in central offices "offer basic telephone service plus the advanced custom calling features"). Applied to the AHC's findings at issue in this appeal, that would mean that the "local loop" and "central switching office," combined, provide "basic telephone service."[9]

As in its first decision, on remand the AHC did not define "basic telephone service." Again, it used the term as a heading. App. A15. Within that section the AHC included subsections discussing "Call Origination" (App. A15-A19; the "local loop" and the switch), "Calls to Other Central Offices" (App. A19-A20; the central processor and SS7 data link), "Toll Calls" (App. A20; long distance service), "Transmission of Analog and Digital Signals" (App. A21-22; transmission, not differentiated between local loops, switches, and trunk

lines), and “SS7” (App. A22-23). The broad range of functions included under the “Basic Telephone Service” banner suggests that the AHC concluded, on remand, that “basic telephone service” is the entire package provided by Southwestern Bell – except for separately billed “vertical services” (which are discussed at App. A23-25).

Our own personal experience as purchasers of telephone services adds no clarity to the decisions of the AHC or this Court. A customer’s definition of “basic telephone service” would logically be based on what the customer sees in billing – *i.e.*, local telephone service, excluding long distance, extended area, optional features, etc. But use of such a definition makes no sense in the context of the sales and use tax law, for it is purely an accounting measure developed by the telephone companies and regulators; it has no relationship to what is “manufactured” in a telecommunications system. The definition that makes the most sense, in light of the Court’s description of

what “manufacturing” takes place, is the first and narrowest one.

IV. Availability of the “manufacturing” exemption.

The Director raises four points on appeal. All of them address the scope of the “integrated plant doctrine.” The first addresses whether Southwestern Bell is entitled to any refund at all. The second addresses a particularly problematic aspect of the AHC’s interpretation of the “integrated plant” doctrine. The third and fourth address particular subsets of the machinery and equipment at issue.

A. The AHC erred in finding that equipment used by Southwestern Bell in providing telephone service is exempt from sales and use tax because that equipment is not used directly in manufacturing in that the manufacturing itself – the creation of a transmittable signal from a voice and the transformation of such a signal into a reproduction of a voice – takes place on

equipment that is owned, maintained, and operated at a different location by a different person.

In *SW Bell I*, this Court specifically recognized one "product" that is "manufactured" in the telephone system: the reproduction of a human voice.

> [T]he human voice . . . cannot be heard from residence to residence, from office to office, or from town to town. The listener requires that the voice be "manufactured" into electronic impulses that can be transmitted and reproduced into an understandable replica. The end "product" is not the same human voice, but a complete reproduction of it, with new value to a listener who could not otherwise hear or understand it.

78 S.W.3d at 768. The transformation of voice to electronic signal – and the corresponding transformation of electronic signal into a reproduction of the original voice – was the subject of a number of the findings in the 2001 AHC decision in this case:

> Phone sets convert the sound of a voice into an analog electrical signal. This signal varies in frequency and amplitude in order to transmit a signal that can be reproduced to sound like the original voice.

A.R. 9, ¶ 3.

> [A]n analog signal enters Bell's telephone system through the customer's telephone, and the person receiving the call receives an analog signal at the other end. The sound of a human voice goes into the telephone on one end, and the sound of that voice comes out of the telephone at the other end.

A.R. 10-11, ¶ 8. SW Bell's expert confirmed that finding in his testimony on remand:

> When you speak, you generate an analog signal from your voice, but it's generated by air pressure so that the signal of a voice as you and I are talking is a transmission of air pressure waves back and forth between us that impacts our ear[,] causes it to vibrate, and so on.

> The microphone or the mouthpiece of the telephone set takes those air pressure waves and converts them to electrical signals by vibrating and interrupting the . . . DC current that is flowing through the loop. So . . . you start off with one type signal. *The phone converts it to another.* It leaves the phone set as an analog signal.

Oct. 6, 2003 Tr. at 48-49 (emphasis added). "The phone" is, of course, located on the customer's premises. In a video presentation (Exhibit 42), SW Bell's expert explained to Commissioner Winn that customers are responsible for everything on their side of the "network interface device," which for residential customers, as he showed, sits outside the home. *See* also Exhibit 43. Obviously, these days, the customer owns, operates, and maintains the telephone set.

Because what this Court identified as "manufacturing" takes place on equipment owned and controlled by customers, and at locations owned and controlled by customers, the AHC's conclusion is

problematic in at least two respects. First, if what happens on the telephone set is the real "manufacturing" in the telephone system, by granting the exemption to someone who merely connects to and supplies the telephone set the AHC is erasing the line that has long enclosed "manufacturing." Second, if the "manufacturing" involves both the customer and the telephone company, the AHC has taken the unprecedented step of permitting one of two unrelated persons operating in two different locations to invoke the exception without the other. This Court should hold the "integrated plant doctrine" within reasonable bounds.

From *West Lake Quarry* in 1970 until *Utilicorp* in 2001, when considering whether particular equipment was "used directly in manufacturing," this Court maintained a line between equipment that is used to create a product and equipment that deals with a product once it is created. The Court stretched the "manufacturing" side of the line perhaps near the breaking point in *Floyd Charcoal*. But it never allowed the "integrated plant

doctrine" to entirely erase that line. And there is no suggestion in *SW Bell I* that the Court intended to erase that line – neither generally, nor as to the telecommunications industry specifically.

The same was true in the first "used directly" case, *West Lake Quarry*. There, the Court refused to permit the taxpayer to use the exemption to cover equipment that was necessary to place the completed product in the purchasers' trucks. 451 S.W.2d at 143.

That line is threatened here. The only "product" specifically identified in *SW Bell I* is the electronic impulse that can be transmitted. And that product is complete before the electronic signal crosses the "network interface" onto the Southwestern Bell system. The Court should not erase the bright line applied in *West Lake Quarry* and elsewhere to grant the "manufacturing" exemption to someone who doesn't actually manufacture, but whose equipment supplies the manufacturer.

The Court should refuse to follow *Floyd Charcoal* to the extent the Court there crossed that bright line. The sacking equipment did not create a "product"; it merely packaged the completed product in a form that made it acceptable to consumers. Packaging was a service connected with marketing, not a step in manufacturing. It may have been essential to selling the product, but it was not essential to creating it. And the fact that the packaging took place under the same roof as the manufacturing (which is not true here, of course) should not be a basis for erasing the line that confines the exemption to manufacturing itself.

The Court has, of course, rejected the premise that to qualify under the "integrated plant doctrine," equipment must be at a single location in order to be "used directly in manufacturing." That rejection is a logical outgrowth of electronic manufacturing, where the "product" while being "manufactured" can easily be transmitted from one computer to another, whether those machines are located alongside each other or thousands

of miles apart. Thus in both *Concord Publishing* and *DST Systems*, the Court applied the exemption to steps in the manufacture of such products when the equipment is found at two different locations. But the Court has never suggested that the integrated plant doctrine can extend beyond the location and equipment involved in manufacturing to include equipment used to supply some service that gives that manufacturing value.

The court did allow the exemption outside the electronic context for laboratory equipment and equipment used to move materials between facilities at a single location during manufacturing in *Noranda Aluminum*. 599 S.W.2d at 3. But that cannot justify this new extension. Even there, the Court took no step toward erasing the line that confines the exemption to the actual manufacturing of a product within – not between – one or more "plants." And it reinforced that concept in *House of Lloyd*. There the Court held: "Any 'manufacturing' or 'fabricating' of the merchandise items that appellant sells was complete prior to those items

being sorted and placed in the cardboard boxes for shipping." 824 S.W.2d at 919. Having drawn a bright line at the point where manufacture is complete, the Court refused to extend the exemption – even by means of the "integrated plant doctrine" – to cover equipment used from that point forward. The Court should preserve that line here.

Assuming that the "product" here is broader than just the creation of signals from voices and the creation of voices from signals, the AHC moves beyond this Court's "integrated plant doctrine" precedents in another notable respect. It erases – for the very first time – boundaries of ownership and control.

Until 1982, the "manufacturing" involved in each case decided by this Court had been performed by a single corporation. The Court did "recognize[] that portions of a newspaper may be produced in separate locations by separate corporations, but still be considered part of one publication." *Concord Publishing*,

916 S.W.2d at 193. The Court followed that course in *Concord Publishing*, *see id*., and in *DST Systems*, *see* 43 S.W.3d at 800-801. But in every one of those cases, the two corporations had common ownership. *Daily Record Co.*, 629 S.W.2d at 349 ("Daily Record Company is a newspaper publishing corporation which also engages in the commercial printing business as Mid-American Printing Company")[10]; *Concord Publishing*, 916 S.W.2d at 189 ("Cape and Concord have been under common ownership since 1986."); *DST Services*, 43 S.W.3d at 800-801 ("In 1991, DST formed Output Technologies, Inc., a wholly owned subsidiary," which later "acquired Mail Processing Systems, Inc."). The Court has never carried the "integrated plant doctrine" so far as to allow a corporation to use the exemption when a key element of manufacturing takes place not just at a different location, but in a device owned, operated, and maintained by a customer. The Court should not sanction the AHC's decision to do so now.

That decision is not compelled by the "law of the case." In ***SW Bell I***, the Court did broadly conclude that "[b]asic telephone service and the various vertical services involved herein are intangible products that are manufactured." 78 S.W.3d at 768. But that does not bar the Court from reversing the AHC and confining the "integrated plant doctrine" developed in the "used directly in" line of cases. Again, this Court did not address that part of the law in its prior decision. And even if it had, the "law of the case" doctrine does not bar the Court from departing from its holding – including whatever it may have meant by "basic telephone service." As noted above, it is within the Court's discretion to depart from the "law of the case" where the prior decision was erroneous. ***See*** Section I. C., ***supra***. And here, the decision would be erroneous if it were read – as Southwestern Bell will presumably suggest – that "manufacturing" is so broad as to include the entire telephone network.

Again, *SW Bell I* dealt only with the question of whether there is a "product" that is "manufactured"; the Court did not address the question of how far the "integrated plant doctrine" extends, nor the question of whether multiple, unrelated entities can combine to perform different functions within a single "plant," and all receive the tax benefits of §144.030.2(4) & (5). The "law of the case" does not dictate the answers to those questions. And the statute from which the answer is derived must be "strictly construed against the taxpayer." *Branson Properties*, 110 S.W.3d at 825.

B. The AHC erred in finding that purchases of machinery and equipment are entitled to the "manufacturing" exemption merely because they "operate harmoniously" with manufacturing equipment because that is not the test under the statute, even applying the "integrated plant doctrine," in that the statute requires actual

use "in" manufacturing, not merely in connection with or alongside manufacturing.

In addressing a relatively small part of Southwestern Bell's refund request – covering pay telephone components – the AHC announced a particularly problematic interpretation of the "integrated plant doctrine." The Court should specifically reject that approach, whose potential future impact dwarfs the impact of its application in this particular case.

The AHC dealt with "pay phone components" as a single category. App. A69. Those "components" include such things as the "little shelf where people can lay their belongings while they're talking on the phone" (Apr. 27, 2000 Tr. at 599) and "a sign that designates a pay phone that is belonging to Southwestern Bell" (*id*. at 604). But when the AHC reached the question of those components, it did not explain how any of those items were "used directly" in manufacturing. In fact, the AHC conceded that pay telephones – much less "components" – "are not absolutely essential to the provision of

telephone service, and are not closely connected to those portions of the system that actually effect a change in the signals." *Id*. Curiously, the AHC then held that "items such as pay phone components should *not* be disqualified on the grounds that they are not 'directly used in manufacturing.'" App. at A69-70 (emphasis added). It reached that conclusion by extending a quotation in *Floyd Charcoal* far beyond the bounds of reasonableness.

In *Niagara Mohawk*, the New York court identified three "basic questions" to be asked in determining whether a particular piece of machinery or equipment is part of a single "integrated plant." *See* 144 N.Y.S.2d at 461, quoted in *Floyd Charcoal*, 599 S.W.2d at 177. When it reached "pay telephone components," the AHC relied solely on the third *Niagara Mohawk* criteria: that the machinery or equipment at issue "operate[s] harmoniously with the admittedly exempt machinery to make an integrated and synchronized system." *Niagara Mohawk*, 144 N.Y.S.2d at 461, quoted in *Floyd Charcoal*, 599 S.W.2d at

177. *See* App. A69. To elevate that factor to dispositive effect would carry the "integrated plant doctrine" far beyond any prior recognition in Missouri law. Indeed, it would erase entirely the line drawn in *Floyd Charcoal* itself, where the court refused to include among the exempt items the equipment that carried the finished product to the customer's vehicle.

That a particular piece of machinery "operates harmoniously" with manufacturing equipment may be a factor when deciding whether to apply the "integrated plant doctrine" to that machinery. But the Court should expressly reject the AHC's premise that merely because something "operates harmoniously" with exempt machinery, it, too, becomes exempt. Unless it is to extend to practically every machine purchased by any manufacturer for any purpose, installed at any location, the "integrated plant doctrine" must require at least consideration of all three criteria identified in *Niagara Mohawk*, 144 N.W.S.2d at 461. In both *Niagara Mohawk* and *Floyd Charcoal*, those criteria were used to

differentiate among items in a single facility. They contemplate a "plant" (or "plants"), not just equipment connected so as to stretch across the landscape. That a particular piece of equipment "operates harmoniously" with machinery in a "plant" should be a prerequisite for coverage, but not enough to qualify unless the equipment is also "necessary to production" and "physically and causally" close to the manufacturing itself. *Floyd Charcoal*, 599 S.W.2d at 177.

C. The AHC erred in finding that equipment used to provide some "vertical services" is exempt from sales and use tax because that equipment is not used directly in manufacturing a product in that it is used merely to bill customers for a product manufactured by other equipment.

As discussed above, the idea that Southwestern Bell's entire network is "used directly in manufacturing" simply cannot be forced into the Court's expressed concept in *SW Bell I* of "manufacturing" as the

transformation of voice into electronic impulses. By contrast, the Court's conclusion that "vertical services" are "manufactured," ***SW Bell I***, 78 S.W.3d at 768, is to some extent consistent with that concept of "manufacturing." The telephone company does "manufacture" some signals that, when received by the consumer's telephone set, convey particular kinds of information – that a call is waiting, the phone number of the person who is calling, etc.

But that does not mean the AHC's holding as to equipment used to provide ***all*** "vertical services" should be affirmed. Though this Court said in ***SW Bell I*** that "the various vertical services involved herein are intangible products that are manufactured" (78 S.W.3d at 768), that broad statement cannot be explained by reference to any aspect of the Court's rationale. Not all "vertical services" involve creation processes even arguably parallel to the creation of electronic impulses by a voice and the subsequent reproduction of the voice.

Again, some "vertical services" do involve the creation of tones and other sounds that consumers use. For example, in "call waiting," telephone company equipment produces a tone that signals to a telephone set user that there is another call. Other "vertical services" involve signals that prompt the consumer's telephone set to act in a certain way. For example, with caller ID, the telephone company creates and the subscriber receives a signal that prompts the telephone set to display the number from which an incoming call is being made. Logically, given the Court's identification of what constitutes "manufacturing" in the telephone context, Southwestern Bell equipment that makes signals sent to the customer's telephone set to provide a "vertical service" could be "manufacturing."

But the AHC, relying on this Court's blanket statement about "vertical services," also included services that produce no "product" of the sort the Court identified in ***SW Bell I***. For example, "vertical services" include "customer billing reports." App. A18

¶61. They include services that involve redirecting an electronic signal, such as call forwarding, or adding a second, simultaneous connection to the central office switch with three-way calling. *Id*. They include other functions that take place solely on the central switch and accompanying hardware, without any signal being sent to the consumer, such as priority call, call blocker, and call trace. *Id*.

Nothing in *SW Bell I* nor in the AHC decision there reversed justifies the extension of the "manufacturing" exemption to the entire panoply of "vertical services." Nor do precedents such as *DST* and *IBM*. True, when compiling bills the company does organize information through computer technology. But the Court should require the AHC to distinguish between those compilations that have independent value, and that the customer purchases because of that value, and those that are merely tools that enable the telephone company to make a profit on the sale of a particular service.

D. The AHC erred in finding that the purchase of equipment used in "interoffice trunking facilities" is exempt from sales and use tax because that equipment is not used directly in manufacturing a product in that such equipment is merely used to provide a service, *i.e.*, transmission.

As discussed above, in II. C., *supra*, ever since *West Lake Quarry*, there has been a distinction in the law between equipment used for manufacturing and equipment used for delivery. That distinction was applied most recently in *Utilicorp United, Inc. v. Director of Revenue*. There the Court noted that the parties agreed that generating electricity is "manufacturing," and addressed the question of "whether the transmission and distribution of electricity are also 'manufacturing.'" 75 S.W.3d at 727. In the process of transmission and distribution, the voltage and amperage of the electricity is modified by the machinery

on whose purchases the Director sought to impose sales and use tax. *Id*. at 728. According to the Court,

> the essential question [is]: Does the transforming and regulating of electricity by these devices result in a "new" product or simply the "repackaging" of an existing product. The repackaging example seem[ed] closer to the point.

Id. That was true because although the changes made transmission possible, the product being purchased by the customer remained the same.

The Court rejected the premise that the "integrated plant doctrine" could cover transmission facilities. As Judge Price recognized in dissent, electricity "is not a product that is" – or even could be – "sold to consumers . . . on a 'cash or carry' basis." *Id* at 730 (Price, J. dissenting). To have a "usable form," it must reach the customer through wires, and to do that at any distance and with the requisite degree of efficiency and safety, it must be modified in various ways. But the Court nonetheless refused to extend the "integrated plant

doctrine" to cover the entire electrical transmission and distribution system.

Yet the AHC did make that extension here when it applied the "manufacturing" exemption to "trunking facilities."[11] According to the AHC, the transmission of electrical current and the transmission of telephone signals are "fundamentally different." App. A67. The AHC cited ***Utilicorp*** for the proposition "that electricity is a complete, usable product when it is generated, and is simply transmitted to the customers in a different voltage or amperage for their use." ***Id***. The error in that part of the AHC decision arises from its failure to distinguish between a "product" that is being "manufactured" and delivery – an accompanying "service" that makes that "product" more useful, valuable, or marketable. A contrary rule would at least arguably extend the "manufacturing" exemption to all aspects of the business of an industrial concern – certainly to the delivery equipment in ***West Lake Quarry***.

The AHC avoids that result by concluding that "telephone service is a 'two-way,' interactive product." App. A67. To provide that product requires the "entire telephone system." *Id*. The AHC ignores the fact that customers can use their telephones quite well without the trunking system. What the trunking system provides is not a "product" that is "manufactured," but a service that gives increased value to the product manufactured by the customer's telephone sets (or, using a broader definition, by those sets when linked to the "local loop"). There is no precedent in this Court's cases for extending the "manufacturing" exemption to such service.

Indeed, such an extension cannot be reconciled with *Utilicorp*. There, the Court rejected a claim that the equipment required to move electricity is part of an "integrated plant" – despite the obvious fact that the entire electrical grid is interconnected. 74 S.W.3d at 729-730. The utility had argued that in order to effectively and efficiently move the electricity, it had to be modified along the way – *i.e.*, that its voltage

and amperage are increased and decreased. *Id*. at 728. The Court held that "the essential product . . . remains fundamentally unchanged." *Id*. at 729-30. Here, to the extent there is a change in the product, the electronic signal, Southwestern Bell must return the product to its prior state before it is of any use to the customer.

The AHC found, correctly, that although much of the telephone system uses electrical signals, it does not provide a precise parallel to the delivery of electricity. But the distinction should not result in one utility being able to invoke the "manufacturing" exemption for the equipment that directs and carries the product to its customers when the other cannot, for at least two reasons.

First, the fact that telephone signals are regenerated – and sometimes transformed from analog to digital and back – does not bring the transmission system inside the "plant." Were that enough, the "plant" could include even satellites that carry telephone calls, receiving a ground signal and generating a

duplicate for broadcast back to earth. There would be literally no physical limits to the "integrated plant." A limitless "integrated plant" could not be reconciled with the insistence in *Floyd Charcoal*, 599 S.W.2d at 117, and *Niagara Mohawk*, 144 N.W.S.2d at 461, on physical proximity.

True, a single plant may be divided among multiple locations. *See*, *e.g.*, *Concord Publishing*, 916 S.W.2d at 192-93. Cable may carry unfinished product among those locations – as do telephone lines connecting laptop modems with manufacturing facilities, which effectively "extend [the manufacturing] process to locations where news events occur." *Id*. at 193. Those cables and lines and equipment associated with them should not be treated as part of the "plant," whether the connection is across a street or across the country. They should not be treated as part of the "plant" regardless of whether the distance requires regeneration or justifies creation of a digital signal to assist the transmission process, particularly where the digitization must be reversed

before the manufacturing can be completed. The AHC's alternative rule, when combined with eliminating the need for companies in manufacturing to be affiliated (*see* pp. 57, *supra*), would extend the "integrated plant doctrine" well beyond the bounds of reasonableness. It would be particularly problematic in that segment of the telecommunications industry that does not even manufacture dial tones and other sounds, and instead performs *only* transmission.[12] And it would be most problematic when the company is providing internet communications, which, unlike the telephone operations of Southwestern Bell, are exempt from the telecommunications services tax under §144.020.1(4).

Second, the fact that telephone service requires two-way transmission does not remove it from the *Utilicorp* holding. In fact, Southwestern Bell did not show that any single piece of the transmission portion of the transmission system performs "two-way" operations. The specific evidence regarding the movement of signals – analog or digital – along wires or fiberoptic cable

suggests one way transmission, just as with electricity. If a second signal flowing the other way on a parallel wire or cable rendered the transmission system part of the "plant," an electrical utility could avoid the *Utilicorp* holding by using parallel wires, sending electricity two different directions along the same route.

If affirmed, the AHC decision will give license to every telecommunications company that provides a "local loop" and switching to invoke the "manufacturing" exemption for its entire system. When combined with the inter-corporate rule *see* p. 57, *supra*, affirmance would also be invoked by telecommunications companies that lack such facilities but that interconnect with Southwestern Bell and other exchange providers – including long distance telephone companies. The legislature could, of course, have exempted all of them – the entire telecommunications industry, including cable television – from paying sales and use tax. But it has not done so explicitly, and the Court should

reject the AHC's essential holding that the legislature has accomplished that task through the "manufacturing" exemption.

The fact remains that customers create and must receive analog signals, and the principal role of the telephone company – and the sole role of "trunking facilities" – is to transmit those signals between customers, not to manufacture an intangible product that the customer purchases.

Conclusion

In view of the foregoing, the Court should reverse the decision of the Administrative Hearing Commission.

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Certification of Service and of Compliance with Rule 84.06(b) and (c)

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